SUPREME COURT, U. S. 880

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

THE LIONEL CORPORATION,
Petitioner,

against

REPUBLIC TECHNOLOGY FUND, INC.,
Respondent.

THE LIONEL CORPORATION,
Petitioner,

against

THE NEW ENGLAND INDUSTRIES, INC.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF RESPONDENTS REPUBLIC TECHNOLOGY FUND, INC. AND THE NEW ENGLAND INDUSTRIES, INC., IN OPPOSITION

SHELDON H. ELSEN
Counsel for Respondents
One Rockefeller Plaza
New York, New York 10020

ORANS, ELSEN & POLSTEIN
LESLIE LUPERT
Of Counsel

INDEX

	PAGE
Opinions Below	1
Jurisdiction	2
Question Presented	2
Statutes and Rules Involved	2
Statement	2
ARGUMENT:	
POINT I—The petition should be denied because no important or novel issue of law is raised, and no conflict with any other circuit is claimed or shown	5
POINT II—Lionel's arguments lack merit	7
Conclusion	9

CITATIONS

Cases:

Kaiser-Frazer Corp. v. *Otis & Co.*, 195 F.2d 838 (2d Cir. 1952), *cert. denied* 344 U.S. 856	6

Statutes:

28 U.S.C. 1254(1)	2
Securities Act of 1933	6
Securities Exchange Act of 1934	6

Miscellaneous:

Stern & Gressman, Supreme Court Practice (4th Ed. 1969)	6, 7

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Opinions Below

The opinion and concurring opinion of the Court of Appeals (Pet. App. 1a-25a)* are reported at 483 F.2d 540, 553 (2d Cir. 1973). The opinion of the trial court (Pet. App. 27a-55a) is reported at 345 F.Supp. 656 (S.D.N.Y. 1972).

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* References with the suffix "a" are to the appendix to the petition for certiorari.

Jurisdiction

The judgment of the Court of Appeals was entered on July 17, 1973. On July 30, 1973, petitioner filed with the Court of Appeals a "Petition for Rehearing With Suggested Rehearing In Banc". On September 6, 1973, the Court of Appeals denied the motion for rehearing. No active Circuit Judge requested that a vote be taken on the question of a rehearing in banc, and the balance of the petition for rehearing was denied on September 6, 1973. The petition for a Writ of Certiorari was filed on December 5, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1), and respondents make no objection to the petition on jurisdictional grounds.

Question Presented

Whether this Court should review a decision of a Court of Appeals which neither conflicts with any other decision nor makes new law, where the principal issues decided by the Court of Appeals are whether items in an interim financial statement were misleading as a matter of law, and where there has been no final judgment.

Statute and Rules Involved

The pertinent statutes and rules are adequately set forth in the petition.

Statement

The facts are well stated in the unanimous* Second Circuit opinion, which the Court has before it in the petition (2a et seq.), and need not be restated at length here.

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* Judge Mulligan, concurring, differed on one point, which is not raised by petitioner in this Court.

The Second Circuit had before it for review a non-jury trial on issues of liability.* Respondents were investors in the stock of petitioner The Lionel Corporation ("Lionel"); their claims involved violations of the Federal securities laws and breaches of contracts to register stock, which arose under State law.

Respondents in 1960 and the spring of 1961 purchased about $1,500,000 of unregistered stock from Hathaway Instruments, Inc. ("Hathaway"), a corporation which merged into Lionel in the fall of 1961. Hathaway had undertaken certain registration obligations, which were later assumed by Lionel. In addition, in the merger agreement, Lionel undertook to file, by October 15, 1961, a registration statement to cover respondents' unregistered stock.

To induce consent to the merger, Lionel issued in a proxy statement unaudited interim financial statements for the six months period ended June 30, 1961, which showed a combined pro forma profit of $245,000, or $.08 per share, and a six months' loss for Lionel of $84,000, or $.06 per share. Lionel also filed a registration statement with the Securities and Exchange Commission, which included the same interim statement. The stockholders of Hathaway approved the merger in October and it became effective in November. Respondents exchanged their Hathaway shares for Lionel shares.**

The very next month, Lionel recorded adjustments, allocable to the entire year, which reduced profits for the year by $2,221,659. These were charged against inventory, sales returns and allowances, research and development and other categories. None of them was reflected in the interim statement submitted to respondents and other investors and filed with the SEC.

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* The District Court ordered a split trial; issues of damages have not yet been tried.

** Respondents held Hathaway common stock and received from Lionel 3¾% convertible preferred stock, but this difference was not material to the issues in the case.

The combined six month pro forma profit of almost a quarter million dollars turned, after the merger, into a loss for the year of $1,898,609, plus $633,668 of special charges, or a loss for the year of over $2.5 million. The six months' earnings per share of $.08 profit turned into a year's loss of $1.71 per share.

Lionel did not disclose that an important recently acquired division (Anton-Imco) had been losing money heavily in the first six months. The $188,842 loss in the Anton-Imco division was not disclosed by the consolidated interim statement; no adjustment had been made to the $998,000 of goodwill carried for Anton-Imco, which would have been charged against profits; the goodwill figure itself was buried in consolidated figures and no uncertainty about the division had been indicated in the notes to Lionel's financial statements.

The explanation which Lionel's auditor and expert witness gave for not writing down goodwill was that Anton-Imco was engaged in the development of a "new machine—I believe it was a money sensor, a money changing device—and based on all the information that was available at that time the prospects for success seemed very reasonable." The auditor relied exclusively on this product to justify Lionel's treatment of the Anton-Imco goodwill.

The notes to the consolidated interim statements themselves stated, however, for Anton-Imco:

> "This company recently designed and developed a currency recognizing device, several prototype models of which have been built up to this time. The device has not yet been marketed and there is no assurance at this time as to whether it will be a profitable item."

The District Court accepted the auditor's testimony; the Second Circuit held, as a matter of law, that Lionel's treatment of Anton-Imco goodwill was misleading.

The Court of Appeals also held that Lionel had had the burden of going forward to justify its treatment of two other items in the interim statement, on which Lionel had not justified its treatment, and remanded for further findings and proceedings consistent with its opinion.

The Court of Appeals also remanded for further findings on materiality, scienter and certain facts involved in the contract causes of action, and stated that, on remand, the District Court should deal with Lionel's affirmative defenses, which it had not yet reached.

Issues of damages have not yet been adjudicated. The registration statement had not become effective with the interim figures referred to, but was amended, and only became effective much later, and then only for a short time.* Respondents' investment was virtually wiped out, and respondents have alleged out of pocket losses of over $1,250,000.

POINT I

The petition should be denied because no important or novel issue of law is raised, and no conflict with any other circuit or case is claimed or shown.

Lionel does not seek review of any novel or important question of law; it cites no conflicts with the decision of any other circuit, or of any other court. At bottom, what Lionel complains of is that it lost the case below. The Court of Appeals for the Second Circuit applied precedents of long standing to the financial statements issued by Lionel, held that three items were misleading as a matter of law, on the record below, and remanded for further findings on the issues of liability, and further proceedings consistent with its decision, presumably including a hear-

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* Another issue below was Lionel's failure to comply with a best efforts obligation to maintain shelf registration for 24 months.

ing on damages and resolution of affirmative defenses, which have not yet been reached (483 F.2d at fn. 13, p. 553).

Even if the unanimous decision of the Court of Appeals had been wrong—as it palpably was not—this case would have been inappropriate for certiorari. As Stern and Gressman put it:

> "It has been reiterated many times that the Supreme Court is not primarily concerned with the correction of errors in lower court decisions. 'The fact that a case may have been wrongly decided as between the parties is not, standing alone, enough to assure certiorari, nor, for that matter, is the fact that a case may have been rightly decided in itself enough to preclude certiorari.' Mr. Justice Harlan, *Manning the Dikes,* 13 Record of N.Y.C.B.A. 541, 551 (1958). The Court's aim, rather, is to resolve the conflicts among the lower courts and to determine questions of importance." Stern and Gressman, *Supreme Court Practice* (4th Ed. 1969), p. 178.

Lionel complains basically that the Second Circuit reversed findings of the District Court (Bonsal, J.) as clearly erroneous. Lionel concedes, however, that the Court of Appeals applied a correct standard of review. Lionel also does not dispute the Second Circuit's conclusion that full disclosure in interim financial statements, issued to the public and governed by the Securities Exchange Act of 1934 and Securities Act of 1933, is required by *Kaiser-Frazer Corp.* v. *Otis & Co.,* 195 F.2d 838 (2d Cir. 1952), *cert. denied,* 344 U.S. 856 (1952). The petitioner cites no authority to the contrary, or any reason to distinguish that twenty-year-old Second Circuit precedent, other than Lionel's displeasure at the result.

No basis has been shown to take seriously a claim that this case is worthy of certiorari. To this must be added the consideration that no final judgment has been reached because further findings are required on liability and because

neither affirmative defenses nor the amount of damages has yet been decided. Certiorari will normally not be granted to a case in this posture "in the absence of some exceptional reason." Stern and Gressman, *op. cit.*, p. 180. No such reason has been shown by Lionel.

POINT II

Lionel's arguments lack merit.

Lionel launches a lengthy attack on the Second Circuit's holding that as a matter of law Lionel misled investors as to the value of its newly acquired Anton-Imco subsidiary.

The facts are that Anton-Imco was losing money heavily ($189,000 in the first six months of 1961), that Lionel carried on its books almost a million dollars of goodwill for that division, that respondents' accounting expert gave his opinion that the losses required a writedown of the division's goodwill, thereby reducing Lionel's profits, that Lionel's expert had to admit that because of the losses a writedown of goodwill should have been considered but said that this factor was outweighed by a reason which Lionel's own financial statement showed to be spurious (483 F.2d at 546), and that investors were kept in the dark about the division's uncertainties by a combination of consolidated accounting methods and non-disclosure in the notes. The issue was discussed at length by the Second Circuit (483 F.2d at 546-48, 550-51), when it unanimously reversed the District Judge, who had no more facts to go on than did the Court of Appeals, but who implicitly condoned what can only be called an outrageous act of concealment and misrepresentation.

Lionel now seeks to justify its treatment by belatedly arguing that it is now permissible to amortize goodwill over a forty-year period.* The argument is that only one-

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* Lionel first raised this argument in its petition for rehearing to the Circuit Court, which was denied.

fortieth of goodwill should have had to be written off in 1961. The requirements on writing down goodwill where operating losses occur are set forth in the Court of Appeals opinion in this case, and in Accounting Research Bulletin 43. In 1970, APB Opinion No. 17 took the position that goodwill should be written down even in a profitable company, over a period that "should not . . . exceed forty years." Lionel extrapolates from this an argument that a company need never write down its goodwill by more than one-fortieth each year, regardless of the actual operations of the company. This is simply not what the Accounting Principles Board opinion states nor what common sense dictates. Anton-Imco suffered a large loss for the first six months of 1961 and the interim statement was materially misleading in failing either to write down the goodwill by a significant amount, or to note some uncertainty with respect to the overall operation of the company.

Lionel also complains that the Court of Appeals erred in placing on Lionel the burden of going forward with evidence to explain its treatment of raw material price variance in its toy and train division, for which Lionel made an adjustment for the twelve months of $140,000, and for which Lionel made no adjustment at all in the interim six months statement. The Court of Appeals excused Lionel from allocating to the interim statement any part of its year-end adjustment for inventory obsolescence in the toy and train division ($262,830), on the theory that obsolescence is recognized when sales are made and that the District Court had found that sales were made at Christmas time, despite testimony by one of respondents' expert witnesses that the key time for determining a toy manufacturer's sales was the March toy show. The Court of Appeals did not hold this finding clearly erroneous, but noted that even if all Lionel's sales were made at the end of the year "it would seem fairly certain that manufacturing and raw material purchases must have occurred

well before June 30, even in the Christmas seasonable toy and train division" (483 F.2d at 548). Lionel produced no records or testimony on its purchases or sales and claimed, both during discovery and trial, that it could not locate them (Trial Transcript, p. 552). The Court of Appeals held only that on such a record Lionel should have been required to go forward with evidence.

The other burden of production item may be analyzed similarly; this Court is referred to the Court of Appeals opinion (483 F.2d at 549).*

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a Writ of Certiorari should be denied.

Dated: New York, New York, December 28, 1973.

Respectfully submitted,

SHELDON H. ELSEN
Counsel for Respondents

ORANS, ELSEN & POLSTEIN
LESLIE LUPERT
Of Counsel

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* Lionel also complains of the application of the securities laws but gives no reason why any such application here was incorrect. It also refers to the age of the case, and mentions that the case was at one point, some years ago, abandoned by predecessor counsel for respondents, but fails to mention that this very lawyer had been retained by Lionel, without respondents' knowledge or consent, and that the lawyer thus retained by Lionel was the one who abandoned the case, without respondents' knowledge or consent. The point was alluded to by the Court of Appeals (483 F.2d at fn. 13, p. 553). The prior abandonment was without prejudice to respondents and the case was thereafter continued and properly prosecuted by present counsel.